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Supreme Court, U.S.
FILED
JUN 11 1987
JOSEPH F. SPANIOL, JR.
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No.

In The

Supreme Court of the United States

October Term, 1986

CLARENCE K. HOWE and MARGARET C. HOWE,

Petitioners,

vs.

THE COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

HERBERT L. ZUCKERMAN
ROBERT J. ALTER
SILLS BECK CUMMIS ZUCKERMAN
RADIN TISCHMAN & EPSTEIN, P.A.
Attorneys for Petitioners
33 Washington Street
Newark, New Jersey 07102
(201) 643-3232

5694
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QUESTION PRESENTED

Whether a non-recourse note secured only by a taxpayer's mineral interest and not entailing an actual annual payment per se cannot constitute the payment required for establishing a valid minimum royalty provision pursuant to Treas. Reg. § 1.612-3(b)(3).

TABLE OF CONTENTS

Page

Question Presented i

Table of Contents ii

Table of Citations ii

Opinions Below 1

Jurisdiction 2

Statutes and Regulations Involved 2

Statement of the Case 3

Reasons for Granting the Writ:

The Decision Below Decided A Recurring Federal Question Involving The Proper Tax Treatment Of Non-Recourse Indebtedness In A Manner That Conflicts With Applicable Decisions Of This Court And In Principle With Decisions Of Other Courts Of Appeals On The Same Matter. . . . 6

Conclusion 13

TABLE OF CITATIONS

Cases Cited:

Brown v. Commissioner of Internal Revenue, 799 F.2d 27 (2d Cir. 1986) 6, 11

Contents

Page

Commissioner v. Tufts, 461 U.S. 300 (1983) ...7, 8, 9, 10, 11

Crane v. Commissioner, 331 U.S. 1 (1947) 7, 9, 10, 11

Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976).....8, 9, 11

Maddrix v. Commissioner, 83 T.C. 613 (1984), aff'd, 780 F.2d 946 (11th Cir. 1986) 5, 6, 10, 11

Mahoney v. United States, 1981-2 U.S.T.C. ¶ 9761 (Ct. Cl. 1981) 9

Ward v. Commissioner, 784 F.2d 1424 (9th Cir. 1986) 6, 10, 11

Statutes Cited:

28 U.S.C. § 1254(1) 2

Internal Revenue Code of 1954 (26 U.S.C.):

§ 465 12

§ 6212 5

§ 6213 5

§ 7442 5

Other Authorities Cited:

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.), Section 1.612 .....i, 2, 6, 10, 12

Contents

Page

APPENDIX

Appendix A — Opinion of the United States Court of Appeals for the Second Circuit 1a

Appendix B — Memorandum Opinion of Special Trial Judge Marvin Peterson of the United States Tax Court 12a

No.

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THE COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The petitioners, Clarence K. Howe and Margaret C. Howe, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered in this proceeding on March 17, 1987.

OPINIONS BELOW

The opinion of the Court of Appeals which appears in the appendix (App. 1a) is reported at 814 F.2d 98 (2d Cir. 1987).

The opinion of the United States Tax Court which appears in the appendix (App. 12a) is reported at T.C. Memo. 1985-408.

JURISDICTION

The judgment of the Court of Appeals for the Second Circuit was entered on March 17, 1987 and a petition for certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.612.3 Depletion; treatment of Bonus and Advanced Royalty

* * *

(b) advanced royalties

* * *

(a) The payor shall treat the advanced royalties paid or accrued in connection with mineral property as deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid or accrued, is sold. For purposes of the preceding sentence, in the case of mineral sold before production the mineral product is considered to be sold when the mineral is produced (i.e., when a mineral product first exists). However, in the case of advanced mineral royalties paid or accrued in connection with mineral property as a result of a minimum royalty

> provision, the payor, at his option, may instead treat the advanced royalties as deductions from gross income for year in which the advanced royalties are paid or accrued. See section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For purposes of this paragraph, a minimum royalty provision requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount.

26 C.F.R. § 1.612-3(b)(3)(1986).

STATEMENT OF THE CASE

Petitioners, accrual basis taxpayers, claimed a loss of $42,620.02 on their joint federal income tax return for 1977 in connection with their participation in an unsuccessful coal mining venture, the Plaza Coal Program (Program). The loss was composed of $42,075.34 in advanced minimum royalties and associated expenses of $544.68. A dispute arose between the petitioners and the respondent when he denied the deduction in its entirety and asserted an income tax deficiency against the petitioners for their 1977 taxable year.

As found by the Second Circuit in its opinion below (Appendix 1a), the Program was a joint venture formed to develop and commercially exploit coal-bearing deposits in Pennsylvania. On December 15, 1977, petitioners entered into a sublease agreement with Fairchild Coal Corporation (the sublessor of certain rights to mine coal) for the right to mine coal for a period of eleven and one-half years unless the sublease was terminated sooner. Petitioners agreed to pay Fairchild a *pro rata* share of

a royalty for the right to mine coal based on the number of tons of coal mined, removed and sold and on the price at which such coal was sold.

Petitioners also agreed to pay a *pro rata* share of a royalty, referred to as a "minimum annual royalty," of $177,650 for eleven and one-half years with $1,598,850 (the first nine years of minimum payment) being due immediately. The $1,598,850, characterized as an "advanced minimum royalty," was to be paid simultaneously with the execution of the sublease by all of the investors in the Program as follows: (1) non-recourse notes in the aggregate amount of $1,292,000, and (2) cash in the aggregate amount of $306,850. Petitioners purchased one-half of one investment unit resulting in their obligation to pay $11,000 cash and a $34,000 non-recourse note to Fairchild. The minimum payments for the tenth and succeeding years were to be paid on December 31 of each such year. The minimum payments described above were to offset and reduce the regular tonnage royalty of $5.50 per ton for the first 32,300 tons of coal mined, removed and sold for each year during the first ten years of the sublease. The minimum payments for the tenth and succeeding years were to be reduced by the tonnage royalty payable during each such year of the sublease.

The non-recourse notes used to satisfy the minimum royalty obligation bore an interest rate of six percent and were payable thirty days after the end of each month beginning December 31, 1977, in an amount equal to $5.65 multiplied by the number of tons of coal up to 1,700 tons mined and removed during the year, in proportion to the debtor's share of the sublease. To the extent the payments described above made during the year totaled an amount less than a minimum amount specified in the note, the difference was due and payable on December 1 of the year in which the shortfall occurred. The note set out the minimum payments for owners of one investment unit as follows:

1978	4,000
1979	8,000
1980	8,000
1981	8,000
1982	8,000
1983	8,000
1984	8,000
1985	8,000
1986	8,000

Any unpaid principal or accrued interest was due on December 31, 1986, or upon earlier termination of the borrower's sublease.

Upon default of either the note or the royalty obligation, Fairchild Coal Corporation could look only to the collateral described in the sublease for payment. The collateral was limited to (1) the coal and other rights granted under the sublease; (2) improvements, buildings, structures, equipment, machinery and other personal property of the sublessees used in connection with the operations under the sublease; and (3) any proceeds from property described in (1) and (2).

After receiving a statutory notice of deficiency, the petitioners invoked the jurisdiction of the tax court under I.R.C. §§ 6212, 6213, and 7442 by timely filing a petition seeking a judicial redetermination of the resulting income tax deficiency asserted against them for 1977 by the respondent.

Thereafter, the respondent filed a pre-trial motion for a partial summary judgment in the tax court case and the petitioners filed a notice of objection based upon the ground that they should be afforded an opportunity to prove at a trial the bona fide economic nature of their non-recourse indebtedness.

The tax court, relying on its decision in *Maddrix v.*

Commissioner of Internal Revenue, 83 T.C. 613 (1984), *aff'd,* 780 F.2d 946 (11th Cir. 1986) and *Ward v. Commissioner of Internal Revenue,* 784 F.2d 1424 (9th Cir. 1986), concluded that the petitioners' obligation to pay royalties was not sufficiently definite to satisfy the requirements of Treas. Reg. § 1.612-3(b)(3) as a matter of law because a non-recourse note secured only by the petitioners' mineral interest was, *a priori,* speculative. (*See* Appendix 12a.) The tax court thereupon granted the respondent's motion for summary judgment as to the non-deductibility of the petitioners' payments under Treas. Reg. § 1.612-3(b)(3).

Following the tax court's decision, the petitioners timely appealed, and the United States Court of Appeals for the Second Circuit affirmed the tax court in a published opinion (Appendix 1a) reported at 814 F.2d 98 (2d Cir. 1987) relying on its decision in *Brown v. Commissioner of Internal Revenue,* 799 F.2d 27 (2d Cir. 1986).

REASONS FOR GRANTING THE WRIT

The Decision Below Decided A Recurring Federal Question Involving The Proper Tax Treatment Of Non-Recourse Indebtedness In A Manner That Conflicts With Applicable Decisions Of This Court And In Principle With Decisions Of Other Courts Of Appeals On The Same Matter.

It is the petitioners' position that there can be a legitimate minimum royalty provision pursuant to § 1.612-3(b)(3), Income Tax Regulations, if the royalty obligation is supported by a bona fide promissory note obligation.

The Second Circuit in its opinion below found that the payment of a portion of an advanced minimum royalty by a non-recourse note which did not entail an actual annual payment because a failure to make a payment did not result in the loss

of all lease rights within one year, nullified the requirement contained in the subject Sublease Agreement and Note that a substantially uniform set amount of royalties be paid at least annually over the life of the sublease. The petitioners submit that such a decision conflicts with well established law regarding the standard for determining whether non-recourse obligations are illusory or genuine for tax purposes.

In *Commissioner v. Tufts,* 461 U.S. 300 (1983), this Court set forth the legal effect of a non-recourse obligation. The decision held that when a partnership sold an apartment complex subject to a non-recourse mortgage, the amount of which exceeded the fair market value of the realty, the partnership's amount realized included the full amount of the non-recourse mortgage. In reaching this result, this Court relied on the principle that a non-recourse obligation can be valid debt for tax purposes:

> The only difference between [a non-recourse] mortgage and one on which the borrower is personally liable is that the mortgagee's remedy is limited to foreclosing on the secured property. This difference does not alter the nature of the obligation; its only effect is to shift from the borrower to the lender any potential loss cause by devaluation of the property. [461 U.S. at 311-12.]

Accord, Crane v. Commissioner, 331 U.S. 1 (1947) ("[W]e are more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations").

The holding of this Court in *Tufts* expands on the principles set forth in *Estate of Franklin v. Commissioner,* 544 F.2d 1045 (9th Cir. 1976) where the reasoning process to be followed in determining the validity of non-recourse indebtedness for tax purposes was explained. In *Franklin,* a limited partnership purchased a motel with a non-recourse obligation that exceeded the fair market value of the property. In this situation the partnership did not have the economic incentive to make the uniform monthly payments of principal and interest required by the sales agreement. The validity of a non-recourse obligation turned on whether the obligor had the economic incentive to make payments:

> An acquisition such as that of [the partnership] if at a price approximately equal to the fair market value of the property under ordinary circumstances would rather quickly yield an equity in the property which the purchaser could not prudently abandon. This is the stuff of substance. It meshes with the form of the transaction and constitutes a sale.
>
> * * *
>
> [I]t has long been recognized that the absence of personal liability for the purchase money debt secured by a mortgage on the acquired property does not deprive the debt of its character as a bona fide debt obligation able to support an interest deduction. However, this is no longer true when it appears that the debt has economic significance only if the property substantially appreciates in value prior to the date at which a very large portion of the purchase price is to be discharged . . . . For a debt to exist, the purchaser, in the absence of personal liability, must confront a situation in

> which it is presently reasonable from an economic point of view for him to make a capital investment in the amount of the unpaid purchase price. [544 F.2d at 1048-49; citation omitted.]

Thus, the holdings of *Tufts, Crane* and *Franklin* show that when sufficient economic incentive exists to pay non-recourse obligations, such obligations are valid. *See also, Mahoney v. United States,* 1981-2 U.S.T.C. ¶ 9761 (Ct. Cl. 1981) (since non-recourse obligation was fixed and unconditional, and security interest in realty was sufficient to satisfy obligation, debt was valid). And any reasoning which denies a taxpayer the opportunity to establish at trial that a sufficient economic incentive existed to pay his non-recourse obligation at the point in time he entered into the transaction is inconsistent with the fundamental income tax concept that the payment of an obligation with a non-recourse note will be respected for income tax purposes as a current payment or the equivalent if the fair market value of the security for the note is approximately equal to or in excess of the face amount of the note.

In the case at bar, the lower courts held in essence that non-recourse obligations which do not entail actual payments are contingent and do not satisfy the Treasury Regulation's requirement that a minimum royalty provision require annual payments. In order to determine whether a non-recourse obligation is contingent, however, as set forth in the aforementioned precedent of this Court, it is necessary to determine whether the taxpayer has the economic incentive to make payments on the note. By relying upon what the lower courts perceived to be the contingent nature of the note used by the petitioners to pay a portion of the advance royalties in issue, the disputed fact of whether a sufficient amount of economically recoverable coal reserves existed to assure the payment of this note became highly relevant and probative of the validity of the petitioners' obligation

under said note and whether it was sufficiently definite to satisfy the requirements of § 1.612-3(b)(3), Income Tax Regulations. Accordingly, since ascertainment of economic incentive is a factual issue summary judgment should not have been rendered on the legal issue of whether the minimum royalty payment requirement of the Treasury Regulation was satisfied.

In sustaining the ultimate result reached by the tax court, the Second Circuit recognized the two conflicting lines of reasoning employed by this Court and the tax court and sought to reconcile them by acknowledging that it was not enough simply to say that because a note was non-recourse, any yearly payment was not required.

The Second Circuit's attempt at reconciliation, however, resulted in a finding which was not only in conflict in principle with the Eleventh Circuit's decision in *Maddrix v. Commissioner*, 83 T.C. 613 (1984), *aff'd*, 780 F.2d 946 (11th Cir. 1986) and the Ninth Circuit's decision in *Ward v. Commissioner of Internal Revenue*, 784 F.2d 1424 (9th Cir. 1986), but more importantly, with the standard utilized by this Court in *Crane* and *Tufts* to determine the validity of non-recourse debt for tax purposes. That is, the analysis for determining whether a non-recourse obligation was illusory or genuine which the Second Circuit substituted for the approach adopted by the tax court, Eleventh Circuit, and Ninth Circuit, directly conflicted with this Court's foregoing precedent because it continued to deny the petitioners their "day in court" in order to demonstrate that at the time they entered into their coal mining investment there was a sufficient economic incentive for them to make the annual payments required by the note and sublease due to the fair market value of the economically recoverable coal reserves which served as security for their note obligation.

Moreover, the analysis employed by the Second Circuit in

relying upon the provisions in the underlying sublease, note and private placement memorandum regarding the sublessor's remedy in the case of default to show that the obligation was contingent and did not require a yearly payment is wrong because it fails to recognize that the limitation on the sublessor's remedy in the case of default is precisely that: a limitation on remedy; not a definition of the sublessee's obligation. Indeed, this was precisely the point made by the Supreme Court in *Commissioner v. Tufts, supra:* "The only difference between [a non-recourse] mortgage and one on which the borrower is personally liable is that the mortgagee's remedy is limited to foreclosing on the secured property. This difference does not alter the nature of the obligation . . ." 461 U.S. 300, 311-12 (1983). The type of provisions relied upon by the Second Circuit in *Brown v. Commissioner, supra,* explains when a default may occur and the consequences of a default, but does not define the terms of the obligation. Under *Brown's* one year forfeiture of interest test, the limitation on remedy defines the obligation to pay annual minimum royalties. Under the petitioners' construction, the limitation on remedy is separate from the obligation to pay annual minimum royalties. In the case at bar, the documents on their face are susceptible under *Tufts* and *Estate of Franklin v. Commissioner, supra,* only to the petitioners' construction. The documents are susceptible to the construction adopted by the Second Circuit only when the sublessee lacks the economic incentive to make payments on the note; a disputed factual issue that as previously stated should have precluded the entry of summary judgment.

Finally, the Second Circuit's decision to only treat a non-recourse obligation which entails an actual annual payment as not being illusory for tax purposes by reason of a one year forfeiture of interest test, is erroneous because, contrary to existing law, it puts accrual-method taxpayers (like petitioners) in the same position as cash-method taxpayers for purposes of the minimum Royalty Regulation.

In this regard, the language of the Treasury Regulation in issue does not require actual payment to effectuate a valid minimum royalty provision. On the contrary, such a reading is inconsistent with the language of the Regulation itself which does not permit an interpretation requiring actual, annual payments by accrual-method taxpayers such as the petitioners. First, the Regulation states throughout that advance minimum royalties are deductible when "*paid or accrued*" (emphasis added). If the Second Circuit's analysis of the Treasury Regulation was correct, there would be no difference between the deductibility of the minimum annual royalty by a cash or accrual-method taxpayer. However, the Regulation mentions *the payment or accrual* of such royalties no less than seven times demonstrating a specific intent to allow the deduction of minimum annual royalty payment obligations incurred by accrual-method taxpayers. Indeed, if a minimum royalty provision could only be supported by a guaranteed actual payment in each year of the sublease, there would be no practical way a taxpayer *could pay or accrue* advance royalties resulting from a minimum royalty provision as is explicitly authorized by the Regulation itself. Such an analysis renders a major portion of the Regulation mere surplusage. If the Second Circuit's analysis was accurate, there should have been no mention in the Regulation of the ability of an accrual-method taxpayer to deduct a minimum royalty obligation *incurred* due to a minimum royalty provision.

Lastly, such substantive analysis violates the constitutional doctrine of separation of powers because it represents a judicial usurpation of a legislative function in that it prematurely achieves the same result which Congress intended to take effect in tax periods subsequent to the year in issue when it expanded the I.R.C. § 465 "at-risk" rules to apply to coal mining activities.

In conclusion, considering the tens of thousands of taxpayers with cases currently docketed in the lower courts involving disputes

with the respondent relating to the proper tax treatment to be accorded to non-recourse debt, the decision below raises an important question and gives this Court an opportunity to provide definitive guidance in an area of the tax law described by the Second Circuit as being "extremely fragile" where there is recurring doubt and litigation.

CONCLUSION

For these reasons, a writ of certiorari should be issued to review the judgment and opinion of the Second Circuit.

Respectfully submitted,

HERBERT L. ZUCKERMAN
ROBERT J. ALTER
SILLS BECK CUMMIS
ZUCKERMAN RADIN
TISCHMAN & EPSTEIN, P.A.
Attorneys for Petitioners

Dated: June 11, 1987

APPENDIX A—OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 707 August Term, 1986

(Argued January 29, 1987 Decided March 17, 1987)

Docket No. 86-4142

CLARENCE K. HOWE and MARGARET C. HOWE,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Before: OAKES, MESKILL and MAHONEY, *Circuit Judges.*

Taxpayers appeal from a judgment entered August 12, 1985, in the United States Tax Court, Peterson, Special Trial Judge, which held that taxpayers' claimed deductions were not allowable because they were not "advance minimum royalties" within the meaning of Treas. Reg. § 1.612-3(b)(3).

Affirmed.

HERBERT L. ZUCKERMAN, Newark, New Jersey (Robert J. Alter, Sills Beck Cummis

Appendix A

Zuckerman Radin Tischman & Epstein, Newark, New Jersey, of counsel),
for Appellants.

FRANCIS M. ALLEGRA, Tax Division, Department of Justice, Washington, D.C. (Roger M. Olsen, Assistant Attorney General, Michael L. Paup, David English Carmack, Tax Division, Department of Justice, Washington, D.C., of counsel),
for Appellee.

MESKILL, *Circuit Judge*:

This appeal is from an August 12, 1985, judgment of the United States Tax Court, Peterson, Special Trial Judge, which granted partial summary judgment to the appellee, Commissioner of Internal Revenue, holding that appellants, Clarence K. Howe and Margaret C. Howe, had improperly deducted $42,620.02 for a claimed advanced minimum royalty payment. Thereafter, the parties stipulated to a settlement of the remaining issues in the case and a final order was entered July 1, 1986. We affirm.

BACKGROUND

Appellants, accrual basis taxpayers, claimed a loss of $42,620.02 on their joint tax return for 1977. The loss was composed of $42,075.34 in advanced minimum royalties and associated expenses of $544.68. Appellants attribute their claimed deduction to their participation in an unsuccessful coal mining

venture, the Plaza Coal Program (Program). The Commissioner denied the deduction in its entirety.

The Program was a joint venture formed to develop and commercially exploit coal-bearing deposits in Pennsylvania. The tax court found the following facts: On December 15, 1977, appellants entered into a sublease agreement with Fairchild Coal Corporation (the sublessor of certain rights to mine coal) for the right to mine coal for a period of eleven and one-half years unless the sublease was terminated sooner. Appellants agreed to pay Fairchild a *pro rata* share of a royalty for the right to mine coal based on the number of tons of coal mined, removed and sold and on the price at which such coal was sold.

Appellants also agreed to pay a *pro rata* share of a royalty, referred to as a "minimum annual royalty," of $177,650 for eleven and one-half years with $1,598,850 (the first nine years of minimum payment) being due immediately. The $1,598,850, characterized as an "advanced minimum royalty," was to be paid simultaneously with the execution of the sublease by all of the investors in the Program as follows: (1) non-recourse notes in the aggregate amount of $1,292,000, and (2) cash in the aggregate amount of $306,850. Appellants purchased one-half of one investment unit resulting in their obligation to pay $11,000 cash and a $34,000 non-recourse note to Fairchild. The minimum payments for the tenth and succeeding years were to be paid on December 31 of each such year. The minimum payments described above were to offset and reduce the regular tonnage royalty of $5.50 per ton for the first 32,300 tons of coal mined, removed and sold for each year during the first ten years of the sublease. The minimum payments for the tenth and succeeding years were to be reduced by the tonnage royalty payable during each such year of the sublease.

Appendix A

The non-recourse notes used to satisfy the minimum royalty obligation bore an interest rate of six percent and were payable thirty days after the end of each month beginning December 31, 1977, in an amount equal to $5.65 multiplied by the number of tons of coal up to 1,700 tons mined and removed during the year, in proportion to the debtor's share of the sublease. To the extent the payments described above made during the year totaled an amount less than a minimum amount specified in the note, the difference was due and payable on December 1 of the year in which the shortfall occurred. The note set out the minimum payments for owners of one investment unit as follows:

1978	4,000
1979	8,000
1980	8,000
1981	8,000
1982	8,000
1983	8,000
1984	8,000
1985	8,000
1986	8,000

Any unpaid principle or accrued interest was due on December 31, 1986, or upon earlier termination of the borrower's sublease.

Upon default of either the note or the royalty obligation, Fairchild Coal Corporation could look only to the collateral described in the sublease for payment. The collateral was limited to (1) the coal and other rights granted under the sublease; (2) improvements, buildings, structures, equipment, machinery and other personal property of the sublessees used in connection with the operations under the sublease; and (3) any proceeds from property described in (1) and (2).

Appendix A

Decision Below

The tax court, relying on its decision in *Maddrix v. C.I.R.*, 83 T.C. 613 (1984), *aff'd*, 780 F.2d 946 (11th Cir. 1986), concluded that the non-recourse nature of appellants' obligations under the note rendered the obligations dependent on the production of coal. The tax court wrote: "A nonrecourse note on which the only periodic payments are contingent on production does not satisfy the provision in the regulation that the agreement of the parties requires annual uniform payments over the life of the lease." *Howe v. C.I.R.*, 50 T.C.M. (CCH) 689, 692 (1985). The court thereupon granted the Commissioner's motion for summary judgment as to the non-deductibility of appellants' payments under Treas. Reg. § 1.612-3(b)(3).

DISCUSSION

A. *Deductibility Under Treas. Reg. § 1.612-3(b)(3)*

The regulation requires (1) substantially uniform (2) annual payments (3) for the life of the lease (4) without regard to actual coal production in order to claim a deduction as an "advance minimum royalty."[1] *See Maddrix*, 780 F.2d at 950; *Ward v. C.I.R.*, 784 F.2d 1424, 1427 (9th Cir. 1986). The precise issue on appeal is whether appellants' obligations under the non-recourse note satisfy the payment requirements of the regulation. Mere "possibilities of payment are insufficient to satisfy Treas. Reg. 1.612-3(b)(3)." *Brown v. C.I.R.*, 799 F.2d 27, 31 (2d Cir. 1986).

Recently, in *Brown*, we considered an investment plan similar to the appellants' plan for purposes of determining deductibility under Treas. Reg. § 1.612-3(b)(3). The tax court decision we reviewed in *Brown* rested on the same analysis employed by the

tax court in this case, *i.e.*, that the non-recourse nature of a taxpayer's obligation, secured only by the taxpayer's interest in a coal mining venture, automatically prevented deductibility under Treas. Reg. § 1.612-3(b)(3). *Id.* at 30. In *Brown* we rejected this analysis and wrote:

> an analysis which focuses solely on the nature of the note and security that guarantees its payment without examining more does not appeal consistent with footnote 33 [*Wing v. C.I.R.*, 81 T.C. 17, 41 n.33 (1983)]. It is not enough simply to say that becuase the note is nonrecourse, any yearly payment is not required. Rather, the inquiry in this limited area should be whether the failure to make a specified annual payment can result in the loss of all lease rights within the one-year period.

Id.

Appellants, however, urge us to reconsider *Brown* in order to permit them to demonstrate that, at the time they entered the Program, they *intended* to honor their obligations under the non-recourse promissory note. Appellants would have us displace *Brown*'s one year forfeiture of interest test with a subjective intent test for purposes of satisfying Treas. Reg. § 1.612-3(b)(3). We decline to do so. "This court is bound by a decision of a prior panel unless and until its nationale is overruled, implicitly or expressly, by the Supreme Court or this court *en banc*." *United States v. Ianniello*, 808 F.2d 184, 190 (ed Cir. 1986). Moreover, *Brown*'s objective standard for determining whether a non-recourse obligation is illusory or genuine offers a workable, commonsense approach in this extremely fragile area of the tax law. We will continue to follow the rule in *Brown*.

Appendix A

The sublease provisions governing appellants' payment obligations are set forth in the margin.[2] Paragraph 10(b) provides that appellants' annual obligations pursuant to the non-recourse promissory note could not be enforced in less than one year and three months after each payment became due. The sublease as a whole makes clear that these promissory note payments are the only payments that might fairly be characterized as substantially uniform and periodic for purposes of satisfying Treas. Reg. § 1.612-3(b)(3). *See Brown,* 799 F.2d at 30-31 (interpreting similar sublease agreement). Paragraph 10(a), which authorizes enforcement of appellants' obligations after only six months, applies only to the lump sum payment due at the inception of the Program and the remaining payments in years ten and eleven. These payments, given the sublease's various provisions for setoffs and staggered payment, are neither substantially uniform nor periodic.

Paragraph 10(b), therefore, is the focus of our analysis. It governs the only payments which might arguably fall within the requirements of the regulation. Paragraph 10(b), however, permits appellants to withhold their payments without penalty of forfeiture for over a year. The appellants' obligations, therefore, fail the *Brown* test.

B. *Appellants' Accrual Basis Challenge*

Appellants contend that Treas. Reg. § 1.612-3(b)(3) is invalid as applied to them because they are accrual method taxpayers. Under the accrual method, receipts and disbursements ordinarily are allocated to the accounting period in which the receipts are earned and the liabilities incurred, regardless of the time of receipt or payment. 2 J. Mertens, *Law of Federal Taxation,* § 12.01 (Rev. 1986). Under this method, an expense is deductible for the taxable

year in which all of the events have occurred that determine the fact and amount of the liability. Treas. Reg. § 1.461-1(a)(2). Appellants complain that the regulation's requirement of actual payment impermissibly contravenes their right to accrue their liabilities for tax purposes without actually paying the liability.

The actual payment requirement of the regulation is designed to create an incentive to undertake the mining of the coal by requiring yearly payments *without regard* to the amount of coal actually mined. *Ward*, 784 F.2d at 1429 & .7. The purpose is to create immediate liability in order to encourage coal production. *Id.* (citing *Wing*, 81 T.C. at 38 n.30.) Likewise, the test articulated in *Brown* focuses on the taxpayer's practical incentive to pay on an annual basis. *Brown*, 799 F.2d at 30-31. Absent this requirement of actual payment on an annual basis, the use of non-recourse notes would enable individuals to realize inflated deductions without actually having to make the underlying outlays.

Appellants' status as accrual method taxpayers does not alter this reality. The relevant focus is not a taxpayer's method of accounting; rather, it is the nature of a taxpayer's obligation to make the payments for which he claims deductions. *Compare* Rev. Ruling 80-70, 1980-1 Cum. Bull. 104 (accrual method taxpayer's obligations under negotiable promissory note payable on demand *satisfy* requirements of Treas. Reg. § 1.612-3(b)(3)) *with Brown*, 799 F.2d at 30-31 (accural method taxpayer's obligations under non-recourse note, where forfeiture postponed for two years after default, *fail to satisfy* requirements of Treas. Reg. § 1.612-3(b)(3)). Although the regulation interferes with the appellants ability to accrue their liabilities, this interference results from the illusory nature of their obligations under the non-recourse note. In this context, we conclude that the regulation properly balances the right to accrue liabilities on the one hand, and the need to provide

an incentive to make the payments underlying the claimed deduction on the other.

The judgment of the tax court is affirmed.

Appendix A

FOOTNOTES

1. Section 1.612-3(b)(3) provides in pertinent part:

> (3) The payor shall treat the advanced royalties paid or accrued in connection with mineral property as deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid or accrued, is sold. For purposes of the preceding sentence, in the case of mineral sold before production the mineral product is considered to be sold when the mineral is produced (i.e., when a mineral product first exists). However, in the case of advanced mineral royalties paid or accrued in connection with mineral property as a result of a minimum royalty provision, the payor, at his option, may instead treat the advanced royalties as deductions from gross income for the year in which the advanced royalties are paid or accrued. See section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For purposes of this paragraph, a minimum royalty provision requires that a substantially uniform amount of royalties tbe paid at least annually either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount.

26 C.F.R. § 1.612-3(b)(3) (1986).

2. The sublease provides in pertinent part:

Appendix A

10. *Events of Default.* The following shall constitute events of default as to any Sublessee hereunder and under the Notes:

(a) If any of Sublessees shall default in the payment of his respective pro rata share of any royalties and/or other monies required hereunder when the same shall become due and payable, and such default shall not have been remedied within ninety (90) days after written notice thereof shall have been received by such Sublessee from Sublessor, provided that with respect solely to the payment of the Minimum Annual Royalty, such default shall not have been remedied within six months after such written notice.

(b) If any of Sublessees shall default in the payment of his respective Note for a period of twelve (12) months after the same shall be due and payable, whether at maturity or at a date fixed for payment or prepayment, and such default shall not have been remedied within three (3) months after written notice thereof shall have been received by such Sublessee from Sublessor.

J. App. at 75.

APPENDIX B—MEMORANDUM OPINION OF SPECIAL TRIAL JUDGE MARVIN PETERSON OF THE UNITED STATES TAX COURT

T.C. Memo. 1985-408

UNITED STATES TAX COURT

CLARENCE K. HOWE AND MARGARET C. HOWE, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 9294-82. Filed August 12, 1985.

Herbert L. Zuckerman, for the petitioners.

Francis J. Strapp, Jr., for the respondent.

MEMORANDUM OPINION

PETERSON, *Special Trial Judge:* This case was assigned to Special Trial Judge Marvin F. Peterson pursuant to section 7456, Internal Revenue Code of 1954, as amended, and Rule 180, et seq.[1]

Respondent determined deficiencies in petitioners' Federal income taxes for the year 1977 and 1978 in the amounts of $17,846.08 and $1,463.00, respectively. The case is before this Court on respondent's motion for partial summary judgment under rule 121 with regard to the year 1977. The issues raised by respondent's motion are (1) whether petitioners may deduct a claimed loss to the extent it resulted from annual minimum

1. All rule references are to the Tax Court Rules of Practice and Procedure. All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

royalty payments and (2) if so, whether the amount of the deduction must be limited to the portion of the claimed annual minimum royalty payments allocable to 1977.

At the time they filed their petition in this case, petitioners resided in Rhinebeck, New York. Petitioners filed joint Federal income tax returns for the years 1977 and 1978 with the Internal Revenue Center at Holtsville, New York.

Petitioners elected to be taxed on the accrual method of accounting with respect to their proportionate share of items of income gain, loss, deductions and credits arising from petitioner Clarence K. Howe's[2] investment in Plaza Coal Program (the Program). On their joint return for 1977, petitioners claimed a business loss of $42,620.02 attributable to participation in the Program. The loss was comprised of advanced minimum royalties in the amount of $42,075.34 and miscellaneous management fees, organizational costs, legal and professional fees in the amount of $544.68. Respondent disallowed the deductions in their entirety. For purposes of ruling on respondent's motion herein, we are concerned solely with the amount of $42,075.34 deducted for royalty payments.

The Program is a joint venture which was formed in late 1977 for the purpose of developing and commercially exploiting coal bearing deposits in the State of Pennsylvania. All of the co-owners of the Plaza Coal Program elected under section 761(a) to be excluded from the application of Subchapter 1 (relating to

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2. The amounts here in dispute relate to the activities of Clarence K. Howe. Margaret C. Howe is a party to this litigation only because she filed a joint return with her husband. When used hereinafter in the singular, "petitioner" will refer to Clarence K. Howe.

partners and partnerships) of the Internal Revenue Code as amended.

Because this case is before the Court on a motion for partial summary judgment under Rule 121, the factual materials presented and the inference to be drawn from such materials must be viewed in the light most favorable to the party opposing the motion. *Jacklin v. Commissioner,* 79 T.C. 340, 344 (1982). In addition, for purposes of this motion, respondent accepts the form of the transactions in question at face value. Therefore, we do the same.

On December 15, 1977, petitioner entered into a sublease agreement with Fairchild Coal Corporation (the sublessor of certain rights to mine coal) for the right to mine coal for a period of 11-1/2 years unless the sublease was terminated sooner. Petitioner agreed to pay a pro rata share of a royalty based on the number of tons of coal mined, removed, and sold and on the price at which such coal was sold.

It was also agreed that petitioner would pay a pro rata share of a minimum annual royalty of $177,650 for 11-1/2 years with $1,598,850 (the first 9 years of minimum payment) being due immediately. The $1,598,850 which was characterized as an advanced minimum royalty was to be paid simultaneously with the execution of the sublease by all of the investors in the Program as follows: (1) nonrecourse notes in the aggregate amount of $1,292,000 and (2) cash in the aggregate amount of $306,850. Petitioner purchased one half of one investment unit resulting in a share of the total amounts due consisting of $11,000 cash and a $34,000 nonrecourse note. The minimum payments for the tenth and succeeding years were to be paid on December 31 of each such year. The minimum payments described above were to offset and reduce the regular tonnage royalty at the rate of

Appendix B

$5.50 per ton for the first 32,300 tons of coal mined, removed, and sold for each year during the first ten years of the sublease. The minimum payments for the tenth and succeeding years were to be reduced by the tonnage royalty payable during each such year of the sublease.

The nonrecourse notes used to satisfy the minimum royalty obligation bore an interest rate of 6% and were payable 30 days after the end of each month beginning December 31, 1977 in an amount equal to $5.65 multiplied by the number of tons of coal up to 1,700 tons mined and removed during the year in proportion to the debtor's share of the sublease.

To the extent the payments described above made during the year totaled an amount less than a minimum amount specified in the note, the difference was due and payable on December 1 of the year in which the shortfall occurred. The note set out the minimum payments for owners of one investment unit as follows:

1978	4,000
1979	8,000
1980	8,000
1981	8,000
1982	8,000
1983	8,000
1984	8,000
1985	8,000
1986	8,000

Any unpaid principal or accrued interest was due on December 31, 1986, or upon earlier termination of the borrower's sublease.

Appendix B

Upon default of either the note or the royalty obligation, Fairchild Coal Corporation could look only to the collateral described in the sublease for payment. The collateral was limited to (1) the coal and other rights granted under the sublease; (2) improvements, buildings, structures, equipment, machinery and other personal property of the sublessees used in connection with the operations under the sublease; and (3) any proceeds from property described in (1) and (2).

Rule 121(b) provides that a decision may be rendered upon motion for summary judgment if it is shown "that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law." and that "partial summary adjudication may be made which does not dispose of all the issues in the case."

Respondent contends that there is no genuine issue of material fact with regard to petitioner's claimed deduction for advanced minimum royalties. He contends further that the royalties paid in 1977 are not deductible in that year as a matter of law because they were not paid pursuant to a minimum royalty provision within the meaning of section 1.612-3(b)(3), Income Tax Regs.

Generally, advanced royalty payments are deductible only in "the year the mineral product, in respect of which the advanced royalties were paid or accrued, is sold." Section 1.612-3(b)(3), Income Tax Regs. In the instant case, no coal was either mined or sold in 1977, therefore, no royalty payments would be deductible under the general rule. However, when the advanced royalty is paid or accrued "as a result of a minimum royalty provision, the payor, at his option, may instead treat the advanced royalties as deductions from gross income for the year in which the advanced royalties are paid or accrued." The regulation goes on to provide:

Appendix B

> For purposes of this paragraph, a minimum royalty provision requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount.

Respondent takes the position that because the royalty obligation and the notes used to satisfy that obligation are nonrecourse, secured only by petitioner's interest in the sublease agreement, payment is conditioned on the sale of coal. Thus, respondent concludes that because of the contingent nature of the obligation, there is no certainty that the minimum royalties will ever be paid as required by section 1.612-3(b)(3), Income Tax Regs. Petitioner argues, however, that the promissory note requires that fixed and definite payments be made each year during the term of the sublease, regardless of the amount received from the sale of coal.

We are concerned here only with whether the obligation to pay royalties is sufficiently definite to satisfy the requirements of section 1.612-3(b)(3), Income Tax Regs. The regulation requires that there be more than a valid obligation to pay royalties. It requires that the provision to pay not only permits, but requires the annual payment of a uniform amount of royalties in the absence of mineral production requiring payment of aggregate royalties in a greater amount. It is not the intent of the parties regarding how the note is to be satisfied that is controlling but, rather, whether the provision itself requires substantially uniform annual payments to be made regardless of coal production. Eventual payment due to adequate security does not establish the existence of a requirement that annual payments be made. *Vastola v. Commissioner*, 84 T.C. 969, 974 (1985); *Maddrix v.*

Appendix B

Commissioner, 83 T.C. 613, 623 (1984), on appeal (11th Cir., May 12, 1985).

In *Maddrix v. Commissioner*, *supra* at 620-623, we found that the nonrecourse note in question was dependent on the production of coal even though the note provided for minimum quarterly installments. We reached this conclusion based on the fact that the note was secured solely by the taxpayer's interest in the sublease, that the taxpayer would not be personally liable for any amounts payable under the note, and that the sublessor would look only to the collateral described in the sublease. Similar to *Maddrix*, the documents in the instant case reveal that petitioner's note was secured solely by his interest in the sublease and that petitioner would not be personally liable for any amounts payable under the note. Thus, we conclude, that the royalty obligation is dependent on the production of coal. A nonrecourse note on which the only periodic payments are contingent on production does not satisfy the provision in the regulation that the agreement of the parties requires annual uniform payments over the life of the lease. *Vastola v. Commissioner, supra* at 975-976.

Petitioner also argues that even if the payments on the nonrecourse note are contigent on the production and sale of coal, summary judgment cannot be rendered on the legal issue of whether the minimum royalty payment requirement of section 1.612-3(b)(3), Income Tax Regs., is satisfied because of the disputed factual question which remains of whether the note had economic substance.

Petitioner argues that where the facts show that the value of the security underlying the nonrecourse obligation exceeds the amount of the obligation, the obligation is valid since there is sufficient economic incentive to pay the nonrecourse obligation

citing *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Crane v. Commissioner*, 331 US. 1 (1957); and *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976). Accordingly, he contends incentive is a factual issue that precludes entry of summary judgment.

We fail to see the relevance of petitioner's argument. Here, there is no issue as to the validity of the nonrecourse note, but whether the obligation to pay meets the mandate of section 1.612-3(b)(3), Income Tax Regs. We conclude the nonrecourse note does not.

Clearly, the obligation does not require petitioner to make annual payments. The obligation only requires annual payments if there is the production and sale of coal. Under these circumstances, petitioner does not qualify for the advanced royalty deduction. *Maddrix v. Commissioner, supra* at 623; *Vastola v. Commissioner, supra* at 973. The fact that there may be eventual payment because of the value of the coal reserves also fails to meet the requirement of the regulation which sets out that a minimum royalty provision must require payment at least annually. *Wing v. Commissioner*, 81 T.C. 17, 40-41 (1983).

Because we have concluded that the royalty provision does not satisfy the requirement of an advanced minimum royalty provision as a matter of law, it is unnecessary to consider respondent's alternative argument that only the portion of the claimed advanced minimum royalties allocable to 1977 is properly deductible.

Respondent's motion for partial summary judgment will be granted.

An appropriate order will be entered.